

**DEPARTMENT OF STATE REVENUE
SUPPLEMENTAL LETTER OF FINDINGS NUMBER: 98-0759SLOF
CORPORATE INCOME TAX
FOR TAX PERIODS: 1995**

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Issues

1. Adjusted Gross Income Tax: Business Income

Authority: IC 6-3-1-20, 45 IAC 3.1-1-1-30, 45 IAC 3.1-1-1-29, The May Department Store Company v. Indiana Department of State Revenue, 749 N.E.2d 651 (Ind. Tax 2001).

The taxpayer protests the classification of certain income as business income.

2. Adjusted Gross Income Tax: Property Ratio

Authority: IC 6-3-2-2, IC 6-8.1-5-1 (b).

The taxpayer protests the use of the property ratio in determining the tax due.

Statement of Facts

The taxpayer is an Ohio corporation whose principal business activity is the producing and wholesaling of shoes and the retailing of apparel, shoes and eyewear. The taxpayer sold its retail apparel and eyewear through its own stores in Indiana and other states. The shoes were sold through its own stores and through stores belonging to other business entities in Indiana and other states. In 1995, the taxpayer sold its shoe division to a Missouri corporation and its retail apparel division to a Connecticut corporation.

The Indiana Department of Revenue (department) audited the taxpayer for the years 1988 through 1996. The taxpayer protested several adjustments. A hearing was held on the protests and a Letter of Findings issued. The taxpayer requested and was granted a rehearing on the issues of the classification of certain receipts as business income and the use of the property ratio in determining the tax due.

1. Adjusted Gross Income Tax: Business Income

The department classified the receipts from the sale of the taxpayer's shoe and retail clothing divisions as business income. Pursuant to this classification, the receipts were apportioned and included in the Indiana sales factor. The taxpayer contends that the receipts should have been classified as derived from non-business income and not included in the taxpayer's Indiana income.

In The May Department Store Company v. Indiana Department of State Revenue, 749 N.E.2d 651 (Ind. Tax 2001), the Indiana Tax Court determined that IC 6-3-1-20 provides for both a transactional test and a functional test in determining whether income is business or non-business in nature. Id. at 662-3.

The Court looked to 45 IAC 3.1-1-29 and 30 for guidance in determining whether income is business or non-business income under the transactional test. These regulations state “. . . the critical element in determining whether income is ‘business income’ or ‘non-business income’ is the identification of the transactions and activity which are the elements of a particular trade or business.” Id. at 664. 45 IAC 3.1-1-30 lists several factors in making this determination. These include the nature of the taxpayer's trade or business; substantiality of the income derived from activities and relationship of income derived from activities to overall activities; frequency, number or continuity of the activities and transactions; length of time income producing property was owned; and taxpayer's purpose in acquiring and holding the property producing income. In May, the Court found that the transactional test was not met when a retailer sold a retailing division to a competitor because the taxpayer was not in the business of selling entire divisions. Id. at 664.

The nature of this taxpayer's business included the manufacture of shoes and the sale of shoes, apparel and eyeglasses. Almost all of the taxpayer's income derived from transactions associated with these activities. The taxpayer had owned the shoe production and sale businesses for a significant period of time. The sale of the shoe and retail clothing divisions was an unusual transaction for the taxpayer since it was not in the business of selling entire divisions. The sale of these divisions does not meet the transactional test for business income.

The functional test focuses on the property being disposed of by the taxpayer. Id. at 664. Specifically the functional test requires examining the relationship of the property at issue with the business operations of the taxpayer. Id. at 664. In order to satisfy the functional test the property generating income must have been acquired, managed and disposed of by the taxpayer in a process integral to taxpayer's regular trade or business operations. Id. at 664. The Court in May defined “integral” as part or constituent component necessary or essential to complete the whole. Id. at 664-5. Therefore, the proceeds from the sale were not business income under the functional test.

In determining that the income from the sale of the shoe and retail apparel divisions constituted business income, the original Letter of Findings held as follows:

In the taxpayer's situation, a foreign eye care business purchased the taxpayer to acquire the eyeglasses and eye care division. The purchasing corporation

disposed of the shoe division so it could further its regular business operations in the area of eye care. Therefore, the sale of the shoe division was necessary to complete the purchaser's regular trade of providing eye care and eyeglasses. The proceeds of this sale constituted business income under the functional test.

The taxpayer argued that this conclusion was in error because it referred only to the completion of the purchaser's eye care business rather than the taxpayer's eye care business. Further, the taxpayer argues that since it eventually went out of business, the sale of the two divisions could not have been an integral part of the taxpayer's regular trade or business operations.

The purchase of the taxpayer by the foreign eye care business changed the taxpayer's business. After this time, the focus of the taxpayer's business was the eye care division rather than the shoe and retail apparel divisions. The taxpayer corporation was managed in a fashion to promote that eye care business. Management decisions were made to make the taxpayer's eye care business as complementary to the purchaser's eye care business as possible. The shoe and retail apparel divisions would not further that function of the taxpayer's eye care business and its merger with the foreign corporation. Therefore, the sale of the two divisions actually was necessary and integral to the taxpayer's overall business purpose of preparing the taxpayer's business for full merger with the purchaser's business. After the merger, it was unnecessary to have two corporate structures to manage the combined eye care businesses. Therefore, the taxpayer corporation was dissolved. That later dissolution did not, however, indicate that the earlier sale of the divisions was not integral to the taxpayer's business at the time of the sale prior to the dissolution of the corporation.

The income from the sale of the shoe and retail apparel divisions constituted business income.

Finding

The taxpayer's protest is denied.

2. Adjusted Gross Income Tax: Property Ratio

Pursuant to IC 6-3-2-2, taxpayer corporations must pay adjusted gross income tax on the proportion of the corporation's business income that was derived from Indiana. The income from the sale of the retail apparel and shoe divisions had been determined to be business income. Therefore, a determination had to be made as to what percentage of the income would be properly apportioned to Indiana. In the audit, the department calculated a ratio comparing the property in Indiana to property located elsewhere. The department then multiplied the entire amount of the business income by this property ratio to determine the income properly subject to Indiana taxation.

The taxpayer contends that the department erred in using this calculus. Rather, the taxpayer contends, the department should have calculated a ratio comparing the Indiana sales to sales in other states and used this sales ratio to determine the proper amount of tax due. The taxpayer supports this contention by stating that the sales ratio more accurately measures the proportion of the income from Indiana because it is based on pricing, number of items sold, and advertising.

All tax assessments are presumed to be accurate and the taxpayer bears the burden of proving that any assessment is incorrect. IC 6-8.1-5-1 (b). The department used the property ratio because those were the figures used in the taxpayer's workpapers and the taxpayer had used the property ratio to determine its Indiana gross income tax liability. The taxpayer was unable to sustain its burden of proving that it was incorrect for the department to use the property ratio in determining the adjusted gross income tax due to Indiana on the income from the sale of the shoe and retail apparel divisions.

Finding

The taxpayer's protest is denied.

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